What Does Safe Harbor Mean, Exactly?

Facts

When we set up our new 401(k) plan last year, we decided not to add a safe harbor provision because we were not in a position to commit to the required contribution. Then we heard our TPA say something about our deferral deposits fitting within the safe harbor deadline. Now I'm just confused.

Question

It seems like the term "safe harbor" is thrown around quite a lot in different contexts. What does it actually mean?

Answer

Wait, what? Using the same word to refer to different things is confusing? Of course it is, and we are here to clear things up for you.

As the sponsor of a 401(k) plan, you're already likely acquainted with the fact that there are many rules and regulations. Many of those requirements can be somewhat subjective, making it less than certain as to whether your plan is truly in compliance. That is where the concept of a "safe harbor" comes into play.

Basically, a safe harbor is a way to take away some of that guesswork. Regardless of the context (at least within the retirement plan world), a safe harbor offers a compliance guarantee - usually in exchange for some of the flexibility that would otherwise be allowed. Put another way, a safe harbor is a precise way to meet a general rule. Let's take a look at some examples.

Deferral Deposits

The Department of Labor's rules require that companies deposit employee 401(k) deferrals as soon as they can reasonably be segregated from company assets. That is the general rule. However, the DOL also provides a safe harbor for smaller plans that says deposits are considered timely if made within seven business days following each pay date, even if the company is able to make the deposits more quickly. "As soon as possible" is subjective; whereas, seven business days is a line in the sand. A company could try to make the case to the DOL that eight days is the earliest they can make the deposit, an argument they may or may not win. Or, they could accelerate the process to get the deposit in a day earlier and be assured they are in compliance.

Hardship Distributions

IRS rules offer two broad options in how to determine whether an employee has a financial hardship that qualifies for a hardship distribution. You guessed it – a general standard and a safe harbor standard. The safe harbor standard lists six reasons that qualify as hardships – things like purchasing a primary residence or paying unreimbursed medical bills. The general standard, on the other hand, is based on the facts and circumstances of each situation and allows a plan sponsor to approve a hardship distribution even if it doesn't appear on that safe harbor list. Consider an employee who has no money to repair a broken-down car, leaving him or her with no way to get to work. That very clearly does not qualify under the safe harbor standards, but a plan that uses the general standard could decide that these facts pose a hardship for the employee and allow the distribution. The general standard requires more documentation on the part of the plan sponsor, and the IRS could always disagree with the determination. That's the trade-off: the safe harbor standard is a sure thing but is less flexible and the general standard is more flexible but is not a sure thing.

Nondiscrimination Testing

These tests are in place to ensure that benefits provided to highly compensated employees (HCEs) are not disproportionate to those provided to non-HCEs. One of the tests that applies to 401(k) plans is the actual deferral percentage (ADP) test, which compares the average deferral rates of the two groups. Generally speaking, if the spread is more than two percentage points, the test fails and must be corrected by either returning contributions to the HCEs or the company contributing more on behalf of the non-HCEs. That is the general rule. While there is a clear pass/fail line, sponsors using this general requirement cannot know whether they pass or fail until the actual data for the year is analyzed following the close of the year. Alternatively, a safe harbor 401(k) plan provides a mechanism to guarantee passage of the ADP test. In short, if a sponsor commits before the start of the year to make certain fully-vested contributions (either a match or profit-sharing-type contribution) for all eligible non-HCEs, that plan is deemed to automatically pass the ADP test.

These are just a few of the situations where you might see the term "safe harbor" used. There are plenty of others, but we won't subject you to all that. Although there are some in the marketplace who might suggest that some or all of these safe harbors are required, that is simply not the case. There is nothing wrong, unnatural, immoral, non-nutritional, or otherwise improper with using a general facts and circumstances standard where one is available. It is really a question of predictability and risk tolerance. A general standard offers more flexibility and is often less expensive. The trade-off is that the results are less predictable, and there is no guarantee the IRS or DOL will agree with the determination. A safe harbor provides a sure thing but is typically more rigid and/or more expensive.

Hopefully, that helps clear up some of the confusion. But, if you come across "safe harbor" in another context and aren't sure what it means, give us a call. More importantly, if you aren't sure whether you should elect a safe harbor or its facts and circumstances counterpart, we are glad to help you work through the options.

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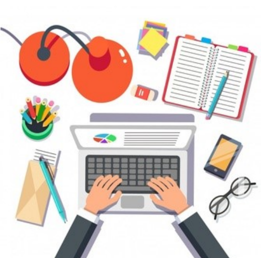

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